(6)

No. 95-860

In The

Supreme Court of the United States

October Term, 1995

BARBARA SMILEY,

Petitioner,

v.

CITIBANK (SOUTH DAKOTA), N.A.,

Respondent.

On Writ Of Certiorari To The
California Supreme Court

BRIEF FOR AMICI IN SUPPORT OF PETITIONER

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MISCELLANEOUS

I. PRELIMINARY STATEMENT

To understand why penalty charges do not constitute § 85 "interest at the rate," an understanding of what charges may be "interest" is necessary. There is no dispute that the § 85 term "interest" may include a number of different types of charges irrespective of the form or the label. For example, "interest" may include flat charges that the borrower is *required* to pay to obtain a consensual loan or forbearance, such as up-front closing fees, taxes, recording fees, or bonuses. All of these up-front charges can be amortized over the loan term (or one year) to calculate an interest rate for the loan or forbearance. The term "interest" may also include "damages" paid after a loan default, such as back-end charges to compensate the lender for the time value of its money. But contract penalties like a $15.00 late fee are not interest in the nature of damages because they are neither based on the unpaid balance nor measured by time. *See Meilink v. Unemployment Resources Comm.*, 314 U.S. 564, 570 (1942) (the distinction of a "penalty as a fixed *ad valorem* amount taking no account of time, and interest which does depend on time, is persuasive.").

While interest in the nature of damages may take many forms, for a charge to constitute a "rate" of "interest," there must be some connection between the amount of the charge and both the delay time and the unpaid balance. Where a sum-certain default charge is contingent (not required for the loan or forbearance) and is not related to time or the unpaid balance (not a ratio charge), it is a contract penalty rather than interest in the nature of damages. This Court has often recognized this distinction. *See United States v. Childs*, 266 U.S. 304, 309 (1924) ("a penalty is a means of punishment; interest a means of compensation"). A penalty charge will exist where there is "no account of time" but interest, by contrast, must take account of time. *Meilink v. Unemployment resources Comm.*, 314 U.S. at 570. Indeed, at common law, penalty charges were against public policy and unenforceable.

Kothe v. R. C. Taylor Trust, 280 U.S. 224, 226 (1930) ("But agreements to pay fixed sums plainly without reasonable relation to any probable damage which may follow a breach will not be enforced").

Smiley, 11 Cal. 4th 138, 4 Cal. Rptr. 441, 900 P.2d 690 (1995) failed to make any distinction between penalty charges and so-called flat or percentage charges for a loan default measured by time and based on the unpaid balance. Judge Arabian (dissenting) correctly addressed the issue whether "late payment penalties" constitute "interest." 900 P.2d at 708-716. Judge George (dissenting) also correctly addressed the issue whether the "type of late payment fees at issue in the present case" constitutes § 85 "interest." *Id.* at 716-720. Unlike the succinct views of Judge Arabian and Judge George, the *Smiley* majority failed to recognize the distinction between contract penalties and interest in the nature of damages following a loan default which was both measured by time and based on the unpaid balance.

Smiley instead held that "We cannot find the meaning of the term 'interest' in Section 85 itself. The provision simply does not define the word." *Id.* at 697. *Smiley* next considered "the source of Section 85 which is Section 30 of the National Bank Act." (*Id.*) and concluded that "Looking at the National Bank Act itself we find no express definition of the terms 'interest' in Section 30. The provision itself does not offer a meaning. Neither does any other." *Id.* at 698-99. *Smiley* erred with respect to all three conclusions.

The Primary Issues That Might Be Decided In This Case

One legal issue to be resolved is whether the § 85 term "interest at the rate" includes contract penalties. Amici submit that while the federal term "interest" may include time-based charges for damages, it does not include contract penalties that lack a "rate" relationship either to time or to the unpaid balance of a loan. Another issue is whether the § 85 term "rate" limits the term

"interest" to detention charges that can be expressed as a "rate of interest." The term "rate" is used ten times in § 85. The term "interest" is used only four times. The term "interest" does not appear even once in § 85 without the term "rate." Accordingly, not all forms of "interest" in the "nature of damages" are allowed by § 85. Only those forms of "interest" that can be expressed as a "rate" are authorized by § 85.[1]

The longstanding common law distinctions between interest rates as damages and contract penalties do not prevent national banks from charging late fees to deter or punish a breach of contract. If a bank's home state permits or limits the contract default charges, then national banks may impose those same contract default charges in their home states as a matter of contract law. The default charges are not, however, "interest" and cannot be exported under the federal definition of "interest" in § 85. Instead, the default charges remain contract default charges authorized by Section 24 (Third) of the National Bank Act, 12 U.S.C. § 24 (Third), which allows banks to "make contracts." Each state may regulate the default charges even-handedly against both in-state and out-of-state lenders. In fact, Section 24 prohibits states from discriminating against national banks. *See, e.g., First Nat'l Bank v. California*, 262 U.S. 366 (1923). In this way, state regulation of contract default charges by a borrower's state does not and cannot subject a national bank to less

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[1] The term "interest rate" therefore has one or more of three characteristics: (i) it is required for the loan and/or (ii) based on the unpaid balance and/or (iii) measured by time. "Flat" up-front charges and interest in the nature of damages, *i.e.*, measured by time and based on the unpaid balance, have one or more of these loan characteristics. Default charges in the "nature of damages" therefore may be interest. But contract penalties which are not based on time and the unpaid balance lack all three interest characteristics and were not "interest" at common law.

favorable conditions than those available to other lenders in the borrower's state.

II. INTEREST OF AMICI

The National Association of Consumer Advocates, Inc. ("NACA") is a non-profit corporation formed in response to the widely expressed belief that an organization of private and public sector attorneys, legal services attorneys, law professors and students, whose primary practice involved the protection and representation of consumers, was needed.

The National Consumer Law Center, Inc., is a non-profit corporation established in 1969 to carry out research, education and litigation involving significant consumer issues. The activities of the National Consumer Law Center, Inc., include research, providing expert and technical assistance on consumer law issues for legal services, pro bono, government and private attorneys. It publishes a twelve-volume series of consumer law treatises, including *The Cost of Credit: Regulation and Legal Challenges* (1995).

Amici submit this brief in support of Petitioner Barbara Smiley. The California Supreme Court's September 1, 1995 divided opinion in *Smiley* presents issues of profound importance to the states and to credit card holders across the country. *Smiley*'s definition of "interest" and subsequent preemption analysis will wreak havoc on state consumer protection laws and will adversely affect millions of consumers. This Court should not allow the South Dakota legislature to nullify California law designed to protect its residents.

III. LEGAL ARGUMENT

I. THE PLAIN MEANING OF "INTEREST" EXCLUDES PENALTY CHARGES

Congress did not explicitly define the term "interest" in § 85 but the meaning of that term may be determined from the following:

- How "interest" was used in the extensive legislative debates that preceded and accompanied the National Bank Act of 1864;
- How "interest" was used by Congress in other provisions of the National Bank Act in 1864 and in the various amendments enacted thereafter;
- How "interest" was defined at common law;
- The common law holdings of this Court (and other courts) that "penalty charges" are not "interest";
- This Court's rulings that Congress must have intended a "strict" and "literal" definition of "interest" so as to avoid subjecting the fledgling national banks to the severe usury penalties of Section 30 (now §§ 85 and 86) of the Act; and
- How the undefined term "interest" was used by Congress in all other known pre-1980 Congressional acts.

Disregarding these definitional sources, *Smiley* relied on non-§ 85 cases to hold that "interest" in § 85 included *all* charges, in any form." *See Smiley*, 900 P.2d at 702-703. While "interest" may indeed include different types and forms of charges, it has never included "all charges, in any form." The common law authorities cited by *Smiley* only hold that interest may include charges in the "nature of damages" for the detention of money. In each and every cited authority, the damages were (i) based on an unpaid balance and (ii) measured by time. Neither *Brown*

v. Hiatts, 82 U.S. (15 Wall.) 177 (1873) nor any other known case decided before 1992 has held that "interest" may include a detention charge that is neither (i) based on the unpaid balance nor (ii) measured by time. These two important features, prominently identified in the 1864 legislative debates are pivotal in determining the definition of the § 85 term "interest."

A. The 38th Congress In 1863 Defined The Term "Interest At The Rate" As Loan Compensation Based On The Unpaid Balance And Measured By Time

Section 30 of the National Bank Act, passed in 1864, was virtually identical to the current laws codified as 12 U.S.C. §§ 85 and 86. *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299, 310 n.23 (1978). Section 30 was preceded by § 46 of the National Currency Act of 1863, 12 Stat. 678, which provided:

> "[E]very association may take, reserve, receive, and charge on any loan, or discount made, or upon any note, bill of exchange, or other evidence of debt, such rate of interest or discount as is for the time *the established rate of interest for delay in the payment of money*, in the absence of contract between the parties, by the laws of the several States in which the associations are respectively located, and no more. . . ."

See 439 U.S. at 310 n.23 (quoting 12 Stat. 678 (emphasis added)). Thus, the Currency Act focused on a time-based *rate* by referring to "interest for delay in the payment of money."

When § 30 of the National Bank Act was passed a year later, the Currency Act's phrase "for delay in the payment of money" was deleted. There is no dispute, however, that the same 38th Congress understood that "rate of interest" itself meant compensation "for the delay in the payment of money." In fact, shortly after passage of § 30 (now § 85), this Court held that "Interest

is given on money demands *as damages for delay in payment*, being just compensation to the plaintiff for a default on the part of his debtor." *Redfield v. Ystalyfera Iron Co.*, 110 U.S. 174, 176 (1884). Thus, the time period of delay was always an important feature of the definition of "interest" in the 1800s.

There is no indication that Congress intended "interest" to include charges unrelated to the time "delay" in payment. Nor is there any indication that the term "interest" included special charges beyond those necessary to "compensate" for the time value (delay) of money. If a detention charge did not take account of time (or the amount of the unpaid loan), it was an unenforceable contract penalty.

B. The 1864 Debates Demonstrate That Congress Understood The Section 30 Term "Interest At The Rate" To Be A Charge Based On The Unpaid Balance And Measured By Time

Smiley ignored the 1864 debates and instead adopted a unique interpretation of "interest" in § 85 that is entirely dependent on the law of a bank's home state. *Id.* at 703. *Smiley* candidly admitted that Congress employed the word "interest" in the "sense of a periodic percentage charge." 900 P.2d at 701. But *Smiley* failed to properly consider the legislative history and context despite this Court's reliance on the very same legislative history to determine the meaning of the § 85 term "located." *See Marquette*, 439 U.S. at 314-15 (emphasizing the importance of the legislative history and context). Worse, *Smiley* did not and could not cite *any pre-1992 case* holding that "interest" included penalty charges not measured by time and/or based on the unpaid balance. *Smiley* not only relied on South Dakota state law for its unique definition of interest but also failed to recognize the fundamental differences between interest in the nature of damages and contract penalties. As the 1864 legislative debates conclusively indicate, Congress intended the § 30 term "interest" to mean a numerical rate, allowed or fixed by

state law, measured by time and based on the unpaid balance. *See e.g.*, the statements of Senator Grimes of Iowa, where he stated "Let me tell the Senate how it will operate in the State [of Iowa] . . . [In Iowa] the "legal rate of interest" is "six per cent" but by special contracts the lender can receive "ten per cent." (Ex. 108, p. 2123)[2] Senator Trumbell of Illinois responded that the "law of Illinois" is precisely like that of Iowa." *Id*. Senator Trumbell also recognized that the rate of interest would be "left to the control of [the] legislature." *Id*. at 2124. Senator Conness of California then stated "let the State fix the rate of interest that shall be charged within its borders." (*Id*.) When Senator Doolittle of Wisconsin inquired "What is the rate," Senator Henderson of Missouri responded "Six per cent," *i.e.*, a percentage rate. Senator Sherman of Ohio (one of the Act's sponsors), then responded to Senator Grimes by stating that the "proposed act" takes the laws of Iowa, [i.e., 10 per cent, then 8 per cent, then 6 per cent] (*Id*. at 2125) and presumes that the people of Iowa have sense enough to pass laws to "fix the rate of interest for their own State." *Id*. at 2126.

The 38th Congress also extensively debated whether the terms "established" or "fixed" were the same or different but under *all* views, Congress recognized that under state law, the term "rate of interest" was a statutory numerical percentage rate. *Id*,. at 2125, 2126 (Senators Sherman and Grimes). The 38th Congress also extensively debated and rejected a federal law that would have required a "uniform rate of interest." (*Id*.) Inherent in the concept "uniform rate of interest" is the recognition that a "rate of interest" is susceptible of being "uniform." Penalty charges by definitiion, are not "uniform" throughout the United States and, therefore, could not constitute a "rate of interest."

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[2] Exhibits are contained in the four volume Appendix of Cases submitted to the California Supreme Court in *Smiley*.

Significantly, the term "in the absence of contract" was deleted in the 1864 Act and in its place, the new term "When no rate is fixed by the laws of the state or territory, the bank may . . . charge a rate not exceeding seven per centum, and such interest may be taken in advance reckoning the days for which the note . . . has to run" was added. Congress, by deleting the 1863 term "in the absence of contract", evidenced its intent to further limit the rates allowed under § 30 to statutory rates fixed by the states. Under the 1864 Act, rates "allowed by the laws of the state" or "fixed by the laws of the state" could be charged, i.e., statutory rates. *Tiffany* thus explicitly refers to state "statutes" as the law of the state. Detention charges (either liquidated damages or penalties) were not "established", "allowed" or "fixed by the laws" of any known state in 1864. "Interest" on a debt was "computed upon the amounts then due . . . to the time of payment," i.e., "interest" "accrue[s]." *Richmond v. Irons*, 121 U.S. 27, 64-65 (1887).

Since states in 1864 did not "fix" or "establish" by statute either "damages" or "penalties," the 38th Congress was clearly referring only to a statutory percentage numerical rate when it enacted § 30.

C. The National Bank Act Itself As Enacted In 1864 Also Demonstrates That Congress Did Not Intend To Expand The Term Interest To Include Penalties

The National Bank Act of 1864 itself unequivocally demonstrates that the 38th Congress knew the difference between a "penalty" and "interest," and did not intend the term "interest" to mean "penalties." A "penalty" was a sum certain *not* measured by time or based on the unpaid balance. *See* §§ 1 and 8 of the 1864 Act which required "penalty" bonds from the Comptroller and his deputy and from national bank officers, and § 41, which required a defaulting national bank to pay the government penalties "in the manner in which penalties are to

be collected from other corporations under the laws of the United States."

The 1864 Act also demonstrates that the 38th Congress understood that the term "interest" was a charge measured by time and based on the unpaid balance. See § 21 (referring to "interest at a rate not less than five per centum per annum,"); § 23 (referring to "interest on the public debt,"); § 38 (referring to "interest is past due and unpaid for a period of six months" which could be a "bad debt" in the absence of collection activities) and § 41 (recognizing that "the treasury may reserve the amount of such duties out of the interest, as it may become due on the bonds."). In each and every instance, the 38th Congress in the 1864 Act used the term "interest" to mean a charge both measured by time and based on the unpaid balance. On the other hand, the term "penalty" was uniformly used by the 38th Congress to mean a sum certain greater than the actual loss.

D. The National Bank Act As Thereafter Amended Demonstrates That Congress Did Not Intend To Expand The Term "Interest" To Include Penalties

The National Bank Act as amended after 1864 also demonstrates how Congress intended the terms "interest", "damages" and penalties to be used.[3] "Interest" in the National Bank Act represents a payment measured by time and based on the unpaid balance. See, e.g., § 84(c)(4) (recognizing that "interest" is compensation that may be paid and guaranteed on bonds, notes, certificates of indebtedness or treasury bills of the United States) and § 175 (recognizing that "interest" is paid on bonds.)

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[3] An amending Congressional interpretation of a statute is entitled to "great weight". *Red Lion Broadcasting Co. v. F.C.C.*, 395 U.S. 367, 380-81, n.8 (1969).

On the other hand, the term "damages' is used to connote actual loss. See § 93(a), requiring NBA directors to be responsible in an "individual capacity for all damages." Finally, the term "Penalties", unlike the terms damages or interest, are understood by Congress to require a payment of more than damages. *See* § 71a (recognizing if a state bank which is a member of the Federal Reserve does not have the required number of directors, it is "subject to forfeiture" of its "Federal Reserve Membership"), and § 93(b)(4), (5), (6), (7) and (8), § 161(c) and § 164, all referring to "penalties" in contrast to "damages" as in § 93(a). In other banking statutes, Congress made these same damage/penalty distinctions. *See, e.g.*, 12 U.S.C. § 1818(i), § 1782(a)(3), (d), § 1785(d)(3) and § 1785(g) all using the term "damages", "interest" and penalties differently.

Therefore, in all known National Bank Act post-1864 amendments, Congress used the terms "interest," "damages" and "penalties" quite differently – "interest" represented loan compensation, "damages" represented a remedy based on the actual loss, and "penalties" represented yet a different remedy consisting of a payment greater than the actual loss.

E. *Smiley* Could Not Cite Even One Common Law Case Or Section 30 Case or Pre-1992 Section 85 Case That Even Suggested That The Section 85 Term "Interest" Includes Penalties

Smiley, after it overlooked how the statutory terms "penalty," "damages" and "interest" were used by the 38th Congress both in the 1864 debates and in the text of § 30 itself and how Congress used these three terms "interest," "damages" and "penalties" in the National Bank Act over the next 130 years, proceeded to "Survey[ ] the National Bank Act . . . [and] discovered a basis for inferring an implied interest definition of the term 'interest' in Section 30." 900 P.2d at 699. The "basis" for *Smiley*'s implied definition consisted of primarily two

common law dictionaries and the one decision in *Brown v. Hiatts*, 82 U.S. (15 Wall.) 177, 185 (1873). Based on this very limited authority, *Smiley* concluded that under the common law the term "interest" included (1) a periodic charge based on a "percentage of a certain sum, either the amount lent or some other, payable absolutely by maturity." (*Id.* at 699) and (2) "damages for its detention" where the damages consisted of a charge measured by time and based on the unpaid balance. *Smiley* also recognized that at common law "the word interest in § 30 was not so limited" (*Id.* at 699) concluding that a so-called flat fee measured by time and based on the unpaid balance could be "interest" citing *Wernwag v. Mothershead*, 3 Blackford 401 (Ind. 1834). *Id.* at 699.[4]

Smiley, however, then extrapolated its common law interest observations to conclude without any supporting authority that "Section 30 of the National Bank Act should be construed to cover [single sum] late payment fees, if such fees are allowed by a national bank's home state." *Id.* at 700, *i.e.*, a penalty charge of $15 not measured by time and not based on the unpaid balance could be § 30 "interest." In essence, *Smiley* held that the § 30 term "interest" was different then and *broader* than the definitions used by the dictionaries and cases upon which it relied. Contrast the scope of the term "interest" under

[4] In *Wernwag*, the interest rate was $5 per week on the unpaid balance. The only other case cited by the *Smiley* Court to support its § 30 "interest" that includes "penalty" holding was *Craig v. Pleiss*, 26 Pa. 261 (1856). *Id.* at 699. In *Craig* the Court only considered a charge for a consensual forbearance of a loan not a charge for a detention of money. *Craig* therefore does not support the *Smiley* Court's holding that penalty charges and interest were the same under § 30. In Pennsylvania, as elsewhere, the penalty charges were not considered to be "interest." *See Huling v. Drexell*, 7 Watts 126, 129 (Pa. 1838), *Daly v. Maitland*, 88 Pa. 384 (1879), *Keck v. Bieber*, 148 Pa. 645, 24 A. 170 (1892) and *Hartranft v. Uhlinger*, 115 Pa. 270, 8 A. 244 (1887).

the common law which did not allow penalty charges or even damages except damages in the nature of interest. A penalty unlike "interest" or "damages" by definition is to provide monetary relief "in excess of . . . actual loss." *Scott v. Donald*, 165 U.S. 58, 86, 17 S.Ct. 265, 267 (1897). *Also see City of Newport v. Fact Concerts, Inc.*, 453 U.S. 247, 260 (1981).[5]

Smiley next attempted to distinguish the numerous common law cases relied on by Petitioner in one of two ways neither of which in fact supported its holding: (1) *Smiley* held that this Court's common law cases relied on by Petitioner did not "define" the term "interest." *Id.* at 699 n.8 and 705 n.15. In each case, however, the Court made it clear that penalty charges were not "interest"; and (2) *Smiley* also held that this Court's other cases relied on by Petitioner like *United States v. Texas*, 507 U.S.

[5] The *Smiley* Court confuses penalty charges with "compensation for use of money, specifically, its retention, beyond the loan's term," 900 P.2d at 700. Here this Court must assume, as pled, that the charge is a "penalty." Significantly, in recent decisions, California appellate courts have upheld significant damage awards against two other banks, finding that their late fees of a minimum of $3 and a maximum of $5 were penalties because they exceeded the banks' costs reasonably related to collecting and accounting for late payments. *Beasley v. Wells Fargo Bank, N.A.*, 235 Cal. App. 3d 1383, 1 Cal. Rptr. 2d 446 (1991) review denied, 1992 Cal. Lexis 1220 (Cal. March 12, 1992) upheld a jury's award of $4 million in damages to a statewide class of California cardholders because of excessive late fees, and *Hitz v. First Interstate Bank*, 38 Cal. App. 4th 274, 279, 44 Cal. Rptr. 2d 890 (1995) upheld a similar damage award. In both instances, after a trial on the merits, fees of $3-5 were found to far exceed the bank's costs attributable to cardholders paying late. Citibank's fees are five times the other two banks' minimum late fee, and three times the maximum. Without a full factual record, including proof of the costs incurred by Citibank by reason of cardholders paying late, it is impossible to conclude that its fees are not penalites.

529 (1993) did not arise under § 30 and therefore were not relevant. *Id.* at 704. *Smiley*, however, failed to cite a single common law case or § 30 or § 85 case that supported its own unique holding that penalty charges could be considered "interest."

Significantly, as early as 1789, Congress recognized that suits for "penalties" were unique and placed such suits in a category separate and distinct from suits for "interest" and "damages." See the Judiciary Acts of 1789, c 20, § 9 which conferred exclusive jurisdiction in the federal courts over "all suits for penalties and forfeitures incurred under the laws of the United States" (1 Stat 73). Congress was therefore well aware of the difference between the terms "interest" and "penalties" and did not use these terms interchangeably.

F. Under The Common Law Definition Of "Interest," Penalty Charges Were Excluded

The only known § 85 case decided before 1992 concerning whether default charges may be "interest" firmly supports the holding that contract penalties are not § 85 "interest." For example, in surveying the common law of penalties and the statutory principles of usury under § 30 (now § 85), the court in *Merchants Nat'l Bank v. Sevier*, 14 F. 662, 663, 667 (C.C.E.D. Ark. 1882), held that a provision in a note imposing collection costs after a loan default was "a stipulation for a penalty or forfeiture [under common law] . . . and void." *Id.* at 663.

Sevier further holds that while unfair collection costs could not be charged as "interest" by a bank, reasonable costs could be imposed *within* a bank's home state as a matter of contract law. *Id.* at 667 (Circuit Judge concurring). *Smiley* also overlooked the very well-reasoned article by Aldebert Hamilton where he discussed at length why penalty charges were illegal and unenforceable at

common law. *See* 14 F. at 667-75.[6] Since such costs are not interest, each state can limit those costs and thus prohibit both in-state and out-of-state banks from charging excessive contingent fees for a contractual breach. *See, e.g., Aldens, Inc. v. Packel*, 524 F.2d 38 (3d Cir. 1975), *cert. denied*, 425 U.S. 943 (1976).

It is a "settled principle of statutory construction that, absent contrary indications, Congress intends to adopt the common law definitions of statutory terms." *United States v. Shabini*, ___ U.S. ___, 115 S.Ct. 382, 384 (1994). The 38th Congress was also well aware that "the popular or perceived import of words furnishes the general rule for the interpretations of public laws." *Maillard v. Lawrence*, 47 U.S. (16 How.) 251, 255 (1853). Here, there is no indication Congress intended a unique definition of "interest" and "rate" independent of their common law meaning. Although *Smiley* admitted that under the common law the definition of "interest" excluded penalty charges, it declined to apply a federal definition because the common law cases were not § 85 cases. 900 P.2d at 704. That illogical reasoning cannot withstand scrutiny. If Congress does not define a term in a statute, the primary other source to determine its meaning is the common law. Obviously, to determine the meaning of a newly enacted statute, a court must refer to analogous cases or sources which necessarily will not have addressed that statute.

Indeed, under all known federal statutes, there is a very strong presumption favoring a common law meaning

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[6] *See also Citizens Nat'l Bank of Orange, VA v. Waugh*, 78 F.2d 325, 329-34 (4th Cir. 1935), where the Court recognized that collection costs (if reasonable) were *not* interest because if "it is properly viewed," it is not "a provision for additional interest exacted by the borrower for the use of money . . . but as a provision for indemnifying the lender for the expense to which he may be put by reason of the borrower's default." *Id.* at 329.

for the words used. This Court recently reaffirmed this presumption in *United States v. Texas*, 507 U.S. 529, 534 (1993), a case that also dealt with the meaning of the term interest in a federal statute. The Court in Texas distinguished between interest and penalty charges and found that penalty charges are "more onerous than the common law" of prejudgment interest. *Id.* at 536 ("unlike the common law, § 3717 also imposes processing fees and penalty charges"). In other words, under the common law, penalty charges are not interest.

In this case, there is nothing in § 85 that " 'speak[s] directly' to the question addressed by the common law." *Id.* at 534. Contrary to *Smiley*, "interest" in § 85 should be construed based on the ordinary, common law meaning of the term. *See Perrin v. United States*, 444 U.S. 37, 42 (1979).

Looking to the common law, it is clear that Congress was well aware of the differences between penalty charges and interest when it passed the National Bank Act in 1864. This Court had previously held that penalty charges were not "interest." *See Tayloe v. Sandiford*, 20 U.S. (7 Wheat.) 13 (1822), where this Court recognized that "In general, a sum of money, in gross, to be paid for the nonperformance of an agreement is considered as a penalty." *Id.* at 17. *Also see Lloyd v. Scott*, 29 U.S. (4 Pet.) 205, 226 (1830) and *Spain v. Hamilton Adm'r.*, 68 U.S. (1 Wall.) 604, 626 (1863).[7]

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[7] Ancient and ecclesiastical law also demonstrates that "interest" and penalties are not the same. At Roman law, the only "interest" that was allowed was that measured by time following a default. In effect, "interesse" (interest) and penalties were the same. But the measure of the "interest" (then called penalty) was based on the unpaid balance and measured by time. Any greater amount was a classic contract penalty ("nomine paenoe"). *See* R. Comyn, *Treatise on the Law of Usury*, pp. 73-74 (R. Pheney, London 1817); *see also Library of Congress v. Shaw*, 478 U.S. 310, 315 n.2 (1986). Today, as in Roman times, "interest" following a loan default is likewise limited and must be measured by the *"id quod interest"* standard. Although "interest" for a loan or forbearance is now allowed as well (at Roman times such interest was not lawful), the time measurement for default charges persists. If a time measurement is absent, the default charge is a contract penalty or forfeiture, because the amount is presumed to exceed the time value of money.

At common law, "special damages" that *compensated* the lender for the detention of money in an amount greater than the actual loss were prohibited. For example, in *Loudon v. Taxing District*, 104 U.S. (14 Otto) 771 (1881), the borrower defaulted, requiring the lender to sell his own assets at a substantial discount. The lender sued for the "costs" of the default. The issue was whether the borrower was liable for more than the time-value of the lender's money. This Court held that interest measured by time is the *only* damage allowed. *Id.* at 774. *See also New Orleans Ins. Co. v. Piaggio*, 83 U.S. (16 Wall.) 378, 386 (1872) (a party "cannot recover special damages for the detention of money due to him beyond what the law allows as interest"). Penalty provisions in contracts (as opposed to tort actions) were generally not enforced where the party was compensated for his loss. *Watts v. Camors*, 115 U.S. 353, 360-61 (1885). *Also see* the Syllabus by Richard Peters, in the Supreme Court Reporter in the case of *Bank of United States v. Owens*, 27 U.S. (2 Peters) 527 n.2 (1829) where he summarized the common law of New York, Massachusetts, Virginia and England and recognized the difference between interest charges and penalties.

Smiley turns the reasoning of *Loudon* and *Piaggio* upside down. Instead of "interest" based on the unpaid balance and measured by time being "the measure of all such damages," it held in essence that "penalties" are the measure of all "interest."

1. Treatises and Other Authorities Uniformly Recognized That The Common Law Term "Interest" Excluded Penalty Charges

Treatise after treatise likewise recognized that "interest" and "penalties" were not the same. In 29 *American and English Encyclopedia of Law 2d* (1904) on "Usury", it is stated that penalty charges (charges within the borrowers' control and, therefore, *not required* for a loan) are *not* usury interest:

> "r. Penalty as Distinguished from Usurious Interest – (a) In General. – Where the statutes prohibit the reservation or taking of interest beyond a certain rate it is generally recognized that there must be an absolute reservation or taking of the excessive interest to constitute usury, and a transaction from which a borrower has the power to relieve himself by the payment of the principal and legal interest within a limited time is not rendered usurious because after such time he cannot free himself without paying more than legal interest. (footnotes omitted) pp. 505-06.

This quote with footnotes cites the law of fifteen states, the United States and England. *Also see* 2 *Parsons on Notes and Bills* 413 (1871).[8]

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[8] The term "penalty" like the term "interest" must be interpreted by a federal common law definition. *Contri Smiley*, 900 P.2d at 707-708. Based on the Petitioner's Complaint, it cannot be assumed that Citibank's $15 late fee is simply "compensation for the use of money." *Id.* at 700. Contrary to *Smiley*'s belief, this is not an issue of form over substance, but is of enormous practical importance. *Smiley* incorrectly postulates that a borrower is equally affected by paying $15 in periodic percentage charges or by paying $15 in late payment fees. *Id.* at 706. But in actuality, the late paying cardholder pays *both* a $15 finance charge and a dual, duplicative $15 late fee.

Historically, there can be no serious question that an interest rate was viewed as a charge based on the unpaid balance and measured by time. *See generally*, J. Knox, *A History of Banking in the United States*, (1908). John Jay Knox was Comptroller of the Currency from 1872 to 1884 and author of the Coinage Act of 1873. He reports that Hugh McCulloch, Comptroller of the Currency in 1863, recommended in his report to Congress that "the penalty usury should be a forfeiture of the interest instead of a forfeiture of the debt, and this uniform rate of interest should be seven percent." *Id.* at 233. Significantly, Comptroller McCulloch distinguished between penalties and interest by using the word "penalty" to denote a sum-certain forfeiture but the word "interest" to denote a time-based "rate." By referring to "interest rates" as "percent" charges, the 38th Congress also understood the term "interest rate" to mean a charge measurable by time and based on an unpaid balance. *See id.* at 238-248.

Quite clearly, the different terms "interest" and "penalties" have long been used to connote different concepts.

2. "Interest" In Section 85 Must Be Accorded A "Strict" And "Literal Construction" As Held By This Court

Assuming, as *Smiley* did (and Amici do not), that there is a definition of "interest" that excludes "penalty charges" and a definition that may include "penalty" charges, the Congressionally understood definition must be applied to "interest" in § 85. This Court has held that, because a violation of § 85 subjects a national bank to the "penalty" of forfeiture of double the interest collected, it must "receive a strict, that is literal construction." *Tiffany v. National Bank*, 85 U.S. (18 Wall.) 409, 410 (1874). This Court has also held that a national bank "is not to be subjected to a penalty unless the words of the statute plainly impose it." *Keppel v. Tiffen Sav. Bank*, 197 U.S. 356,

362 (1905).[9] Therefore, even assuming (and Amici do not) that the term "interest" may be defined to include or exclude penalty charges, it is the "strict" and "literal construction" interpretation Congress intended to avoid subjecting the fledgling national banks to the statutory penalty of Section 30 (now §§ 85 and 86) of the National Bank Act that must be applied.

II. THE UNDEFINED TERM "INTEREST" IN OTHER CONGRESSIONAL ACTS EXCLUDE PENALTY CHARGES

Smiley, in essence, held that the § 85 term "interest" is defined unlike any other known congressional use of the term "interest," when undefined to include penalty charges. It apparently believes that the longstanding and consistent Congressional use of the term "interest" to exclude penalty charges in numerous other legislative acts is of no relevance. After extensive research, Amici are unaware of any other pre-1980 federal act where the *undefined* term "interest" was interpreted to include penalty charges. Moreover, this Court, in *Day v. Woodworth*, 154 U.S. (13 How.) 363 (1851) recognized the rarity of a federal statute allowing a penalty. As of 1851, this Court knew of only one such federal statute. *Id.* at 372.

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[9] Under § 85, this Court has recognized the difference between the term "interest" meaning compensation and "penalties" meaning more than actual loss. *See, First Nat'l. Bank v. Morgan*, 132 U.S. 141, 144 (1889):

> A suit against a national bank to recover back twice the *amount of interest* illegally taken by it *is a suit to recover a penalty* incurred under a law of the United States; . . . so far as suits for *penalties* incurred under the laws of the United States were concerned, to modify the provision in prior enactments that expressly excluded suits for such *penalties* from the cognizance of the state courts.

A. Under the Internal Revenue Act, The Undefined Term "Interest" and Penalties Are Not The Same

Congress used the term "interest" in a number of federal statutes after 1864 and before 1980. In construing those statutes, this Court and federal regulators have repeatedly limited the term "interest" to compensation for the use of money to the exclusion of penalties triggered by the borrower's default. For example, in *Deputy v. DuPont*, 308 U.S. 488, 498 (1940) (an IRS case), this Court recognized the ordinary use of the term "interest" generally "means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." *Also see, Old Colony R.Co. v. Commissioner*, 284 U.S. 552, 561 (1932), ("[T]hat in the common understanding "interest" means what is usually called interest by those who pay and those who receive the amount so denominated in bond and coupon."). In short, here, as in *Noteman v. Welch*, 108 F.2d 206, 214 (1st Cir. 1939) "If the loan contract calls for payments by delinquent borrowers for extra expenses of collection resulting from their own default, such payments would not be called interest."

B. Under the Federal Reserve Act, The Undefined Term "Interest" and Penalties Are Not The Same

The Federal Reserve Board has historically defined "interest" for bank deposits to mean:

> [A]ny payment to or for the account of any depositor as compensation for the use of funds constituting a deposit. A member bank's absorption of expenses incident to providing a normal banking function or its forbearance from charging a fee in connection with such a service is not considered a payment of interest.

12 C.F.R. § 217.2(d). By necessity, bank penalties for administrative collection expenses are not interest.

C. Under The Bankruptcy Act, The Undefined Term "Interest" and Penalties Are Not the Same

In the context of bankruptcy, the plain meaning of "interest" also does not include penalty charges. In *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989), this Court construed the term "interest" in the Bankruptcy Code. This Court stressed that "[t]he plain meaning of legislation should be conclusive, except in rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters." *Id.* at 242. The Court also observed that "interest" is distinct from "fees, costs, or charges." *Id.* at 241 (citation omitted).

D. Under The Truth-In-Lending Act, The Undefined Term "Interest" and Penalties are Not the Same

In the Truth-In-Lending Act (TIL), Congress defined the term "finance charges" (a term that includes interest) to exclude delinquency charges. *See, Johnson v. McCrackin-Sturman Ford, Inc.*, 527 F.2d 257, 265-66 (3d Cir. 1975), where the court defined the pre-TIL congressional understanding of the term "default charges" as follows:

> Prior to enactment of the Act, the terms "default charges" and delinquency charges" had well established meanings in the commercial credit field and in other consumer credit legislation, *and it is certain that Congress was well aware of these definitions.* Since the legislative history of the Act indicates that Congress intended to enact remedies that reflected commercial realities, we presume that Congress meant to ascribe to the terms "default charges" and "delinquency charges" the generally accepted meanings of these terms in the consumer credit industry.

There are numerous other facets of *Johnson* that are particularly relevant. In enacting the Truth-In-Lending Act, Congress recognized that "interest" and "delinquency charges" were mutually exclusive. To state this another way, there is *no* overlap between what Congress considered an "interest" charge (which is part of the "finance charge") and what Congress considered a "delinquency charge."

E. The Undefined Term "Rate" Excludes Single Sum Penalty Charges

It is clear that from 1864 to at least 1980, Congress consistently used the undefined terms "interest" and "rate" to exclude penalty charges.

Recently, in the Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub.L. No. 103-328, 108 Stat. 2338 ("Reigle-Neal Act"), which governs national banks Congress once again made it clear it intended to preserve, not preempt, state consumer protection laws. The Conference Report that accompanied this Act recognized:

> States have a strong interest in the activities and operations of depository institutions doing business within their jurisdictions, regardless of the type of charter an institution holds. In particular, States have a legitimate interest in protecting the rights of their consumers, ...

H.R. Report 103-651, 103d Cong. 2d Sess. 53 (1994).

In this same Act, Congress highlighted its use of the different statutory terms "rate" and "amount." In § 113 of the Reigle-Neal Act, Congress amended the "interest rate" language pertaining to certain agricultural loans covered by the Consolidated Farm and Rural Development Act, 7 U.S.C. § 1927(a). Instead of referring just to "rate of interest", Section 113 is now broader in scope and provides: "Notwithstanding the provision of the constitution or Laws of any state limiting the rate *or amount* of interest. . . . " (emphasis added). Congress thus extended the preemption it intended for those agricultural loans *both* to rates and to flat

"amounts".[10] Congress simultaneously emphasized in § 111(3) that no amendment in the Reigle-Neal Act, including the new language of § 113, was to be construed "as affecting in any way . . . the applicability of § 85." Congress, therefore, codified and highlighted the material differences in scope among § 85 on the one hand, and the new § 113 on the other hand. Accordingly, the Reigle-Neal Act provides yet another indication that Congress considered but elected not to amend § 85 to apply to the "amount" of loan charges but instead consciously limited the scope of § 85 to "rates."[11]

III. NO DEFERENCE IS OWED THE STAFF OPINIONS OF THE OCC

The OCC staff has over the years taken very different and inconsistent positions as to the scope of the § 85 term interest. Pre-February 1995, the OCC staff argued that the § 85 term "interest" could be uniquely defined by each of the fifty state legislatures. After February 1995, it has opined that the § 85 term "interest" has a federal definition which it

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[10] Historically, when Congress intended to preempt flat charges, instead of only "rate", it explicitly stated so in the banking law. *See* 12 U.S.C. § 1735(f)-7a(a)(i) (§ 501 of DIDA), preempting in addition to "rates" "amounts"; *see also* 12 U.S.C. § 1735f-7(a) (§ 529 of DIDA) preempting any "amount of interest" in addition to "rate". Because § 85 preempts only a "rate" of interest", *not* amounts of interest, the statute does not preempt flat charges, but only rates.

[11] In addition, "interest at the rate" in § 85 should be construed no more broadly than the associated § 85 term "discount rate" in the same sentence. *See Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961). Since discount interest (which is collected at the outset of a loan) does not include contingent charges, "rate of interest" likewise cannot include such charges. Moreover, this Court has long recognized that the term "rate" in both terms means the same numerical rate. In short "both are expressly made subject to the same rate of interest." *National Bank v. Johnson*, 104 U.S. 271, 277 (1881).

alone can determine. To support its recent 1996 federal definition, the OCC nonsensically relies on pre-1996 staff opinions and case law that erroneously accorded the § 85 term "interest" a state definition.

A. Pre-February 1, 1995 OCC Staff Opinions Were Based On The Erroneous Belief That State Law Determined The Scope of The § 85 Term "Interest"

The *first* time the OCC staff considered a single sum penalty charge (*i.e.*, a penalty) to be interest was in the August 1988 opinion of Mr. Serino, OCC Deputy Chief Counsel, where he stated that, in *his opinion* (not the opinion of the OCC), under a *state law* definition of "interest," a single sum late fee, (*i.e.*, a penalty) could be interest under § 85. Mr. Serino stated "it is my position" that penalties, even "attorneys' fees," are "interest" under the now discarded contention that the § 85 term "interest" could be defined by each of the fifty state legislatures. OCC Letter No. 452, R. Serino, Deputy Chief Counsel. Reprinted in [1988-89 Transfer Binder] Fed. Banking L.Rep. (CCH) #85, 676 at page 78065-67 (Aug. 11, 1988).

This staff opinion and others of similar ilk are now entitled to no weight because they are based on the erroneous belief that each of the state legislatures can uniquely define and redefine the § 85 term "interest." Moreover, this OCC staff position that § 85 "interest" is defined by the law of the bank's home state – has now been rejected by both Citibank and the OCC itself. In any event, the position of the OCC staff does not necessarily represent the position of the OCC itself. *See NationsBank, N.A. v. Variable Annuity Life Ins. Co.*, 115 S.Ct. 810, 816 (1995).

B. The One Post-February 1995 OCC Opinion – While Purporting To Apply A Federal Definition Of "Interest" – Improperly Relied On Staff Opinions And Case Law That Applied A State Definition

Prior to February, 1995 the opinion of the OCC itself was that penalty charges were not § 85 "interest." *See, e.g.*, the

interpretive letters issued by the Comptroller of the Currency, James J. Saxon. In 1964, Mr. Saxon issued a letter that addressed the meaning of "interest" in 12 U.S.C. § 85 and stated that *"Charges for late payments . . .* are illustrations of charges which are made by some banks which *would not properly be characterized as interest."* OCC Letter, Saxon, J. (June 25, 1964) (emphasis added). (Petitioners' Brief, Ex. B) *Smiley* seemed to believe that the OCC staff letters (stating that a national bank's home state law defined the scope of the § 85 term "interest") represented the position of the OCC but that the opinions of the Comptroller of the Currency himself did not. *Id.* at 702 and 703, n.13.

On February 17, 1995, Julie L. Williams, Chief OCC Counsel, became the first OCC staff employee on behalf of the OCC itself to reject the state law definition of § 85 "interest" theory. *See Smiley*, 900 P.2d at 702. As a result, decisions by courts, the O.C.C. staff and other agencies relying on Mr. Serino's earlier erroneous belief that state law determines the scope of § 85, are entitled to no weight.

The February 1995 Williams' letter, however, is entitled to little, if any, weight for at least three reasons: (1) it relied almost exclusively on case law and staff opinions that used a state not federal definition of § 85 "interest"; (2) it concluded that the § 85 term "interest" must be interpreted broadly and ignored this Court holdings that § 85 "interest" should be interpreted "strictly" and "literally", so a National Bank can avoid the § 86 penalty. *See Tiffany*, 85 U.S. at 410 and *Keppel v. Tiffen Savings Bank*, 197 U.S. at 362; and (3) it relied on cases holding that up front required charges like bonuses, commissions, and charges for mortgage taxes and recording fees are examples of § 85 "interest" when the OCC has since stated that such up front costs may *not* be "interest."[12]

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[12] Moreover, the definition of "interest" in the § 85 cases relied upon by *Smiley* was never in dispute. In these cases since the parties and Courts simply assumed the charge was § 85 "interest", these cases have no precedential value as to the definition of § 85 interest. *See generally Zenith Radio Corp. v. United States*, 437 U.S. 443, 459-62 (1978).

Significantly, less than one month after the Williams' letter, the OCC issued a proposed interpretive rule disagreeing with Williams' "broad" definition of "interest" and concluding that § 85 "interest" does *not* ordinarily include appraisal fees, premiums and commissions attributable to insurance guaranteeing repayment of an extension of credit, finders fees, fees for document preparation or notarizations, or fees incurred to obtain credit reports." *See* 60 Fed.Reg. 11924-11941 (March 3, 1995).[13] Based in part on the OCC's pre-March 3, 1995 position, *Smiley* erroneously concluded that § 85 included all "credit terms," which is clearly inconsistent with the OCC's 1996 definition of the § 85 term "interest."

IV. THE STATES MAY REGULATE A NATIONAL BANK'S TRANSACTIONS WITH STATE RESIDENTS

This Court has long upheld the right of the states to non-discriminatorily regulate national banks insofar as their transactions with state residents. *See, e.g., McClellan v. Chipman*, 164 U.S. 347 (1896) (state fraudulent conveyance statute not pre-empted), *First National Bank v. Missouri*, 263 U.S. 640, 656 (1924) (state statute prohibiting branch banking prohibitions not pre-empted (pre-McFadden Act)), *Lewis v. Fidelity & Deposit Co. of Maryland*, 292 U.S. 559 (1934) (state statute regulating bank guaranties not pre-empted), and *Anderson National Bank v. Luckett*, 321 U.S. 233 (1944) (state statute requiring escheat to state

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[13] On February 9, 1996, the OCC issued its final regulation adopting its new re-definition of § 85 "interest." That OCC regulation will become effective on April 1, 1996. *See* 61 Fed. Reg. 4849-4870 (1996).

of bank deposits not pre-empted). *Also see Citizens Nat'l Bank v. Donnell*, 72 S.W. 925, 931-32 (1903), *aff'd., Citizens Nat'l Bank v. Donnell*, 195 U.S. 369 (1904) (state requirement of a writing prior to charging a higher rate of interest not pre-empted), *New Hampshire Banker's Association v. Nelson*, 336 F.Supp. 1330 (D.N.H. 1972) (state laws regulating bank advertising not pre-empted) and *National State Bank, Elizabeth N.J. v. Long*, 630 F.2d 981 (3d Cir. 1980) (state redlining loan laws regulating national banks not pre-empted). Thus, states can and do regulate a number of national bank transactions within their own boundaries, including a national bank's debt collection activities. *See, National Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353, 362 (1870). Thereafter, this Court in *First Nat. Bank of Charlotte v. Nat. Bank of Baltimore*, 92 U.S. 122, 127 (1875) explicitly recognized with respect to debt collections that a national bank is only allowed the same state rights as a natural person:

> Obligations may be assumed that result unfortunately. Loans or discounts may be made that cannot be met at maturity. Compromise, to avoid or reduce losses are oftentimes the necessary results of this condition of things. These compromises come within the general scope of the powers committed to the Board of Directors and the officers and agents of the bank, and are submitted to their judgment and discretion, except to the extent that they are restrained by the charter or by-laws. *Banks may do, in their behalf, whatever natural persons could do under like circumstances.* (emphasis added).

Also see, Miller v. King, 223 U.S. 505 (1911), where this Court stated that a national bank "[M]ay do those acts and occupy those relations which are usual or necessary in making collections of commercial paper and other evidences of debt" and upheld the national bank's right to file suit on an assigned judgment in a manner allowed by Oregon state law. *Id.* at 510-511.

All parties agree that a National Bank is a "most favored lender" under § 85. Here, however, the well established Congressional policy of "competitive equality" controls and prohibits national banks from exporting non-interest charges (i.e., penalty charges) under § 85 into other states. *See generally, First National Bank v. Dickinson*, 396 U.S. 122, 138 (1969), and *First Nat. Bank of Logan v. Walker Bank & T. Co.*, 385 U.S. 252, 261 (1966) where the Court held that "nor is the Congressional policy of competitive equality with its deference to state standards open to modification by the Comptroller of the Currency" (footnote omitted).

In light of the above, Petitioner's home state can regulate or limit penalty charges as part of California's police power to regulate debt collection activities.

V. CONGRESSIONAL PURPOSES UNDERLYING § 85 ALSO MITIGATE AGAINST AN INTERPRETATION OF THE § 85 TERM "INTEREST AT THE RATE" THAT INCLUDES PENALTY CHARGES

Congress as evidenced by the language of the National Bank Act (§ 85) developed a statutory scheme that protects borrowers in at least four ways: (1) it enables states to protect resident borrowers with respect to penalty charges and other onerous, non-interest charges like attorneys' fees; (2) it enables resident borrowers to retain the benefits of state consumer protection laws that do not regulate both the "interest" and the "rate," but only "amounts" of *non*-interest loan charges that can be imposed; (3) it enables resident borrowers to compare and shop rates of interest based on uniform federal definitions of "interest," and "rate" before they agree to a reservation of interest; and (4) it maintains "competitive equality" between state leaders and national banks.

Moreover, the definitions of § 85 "interest" and "rate" adopted by Congress protects national banks because: (1) it allows national banks to impose penalty charges and attorneys' fees on the same basis as any other lender

within each state by providing § 24 (Third) which has been interpreted to prohibit discrimination against national banks; (2) it is in accordance with this Court's holding that § 85 should be interpreted "strictly" and "literally" to avoid subjecting national banks to statutory penalties; (3) it provides national banks an objective federal § 85 "interest" standard that is not subject to the ephemeral views of the states or the OCC so that national banks can rely on a firm standard; and (4) most significatly it carries out the intent of Congress, as evidenced by the "interest" and "rate" language of the statute itself and the pre-1992 case law all recognizing the difference between the terms "penalties", "interest" and "rates."

CONCLUSION

For the reasons stated above, Amici respectfully request this Court to uphold the position of Petitioner Barbara Smiley, and reverse the lower Court.

Respectfully submitted,

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